MARKET COMMENTARY

Throw the Confetti

Q1, 2021

- At the end of the quarter, investors enjoyed the robust returns of riskier asset classes and policymakers' continued commitment to extraordinary accommodation.
- The celebratory mood is also due to the great work from vaccine developers and distributors as more than 109 million Americans had received at least one dose of the COVID-19 vaccine by the end of the quarter.
- These developments overshadowed the bear market in longer duration bonds and the implosion of a few high-profile hedge funds.
- Inflation remains the key to decoding how long this unsustainable policy support can last. As long as inflation remains contained, investors may continue to throw the confetti.

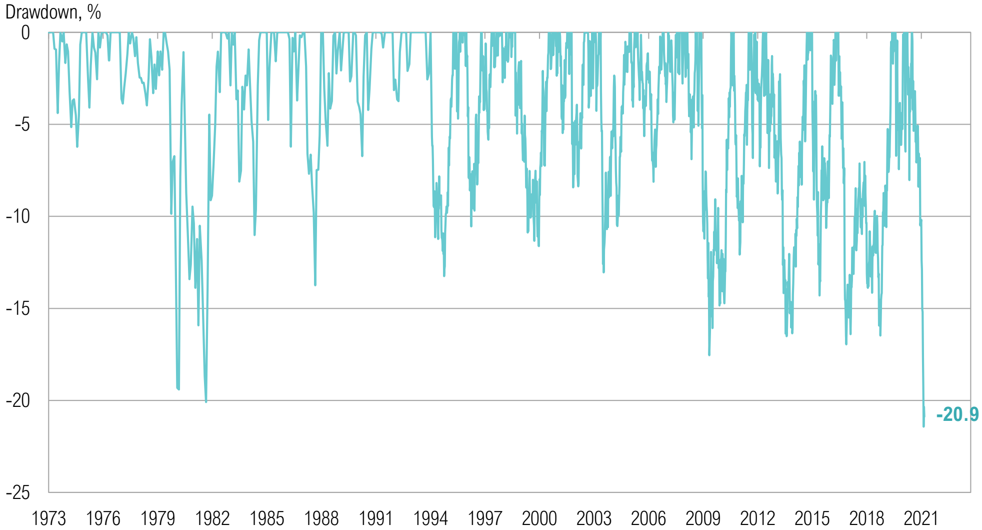
Overview

The quarter was filled with so many colorful events that it made the first three months of 2021 feel like an entire year. In the end, investors had much to celebrate. Equity returns were decidedly positive, and both fiscal and monetary policymakers reiterated their extraordinarily accommodative stances. An even bigger reason to throw confetti was in celebration of the remarkable work of healthcare professionals, essential workers, and vaccine developers. To date, over 109 million Americans have received at least one dose of the COVID-19 vaccine—an amazing feat given the virus hit the U.S. just over one year ago.[1]

During the quarter, the S&P 500 Index rose 6%, helping to overshadow the worst quarterly loss for the U.S. Aggregate Bond Index since the third quarter of 1981.

During the quarter, the S&P 500 Index rose 6%, and other risky assets, such as commodities, were up nearly 7%. This helped overshadow an unusually weak bond market.[2] The BarCap U.S. Aggregate Bond Index lost 3%, posting its worst quarterly loss since the third quarter of 1981, when it lost 4%.[2] To put this return into perspective, there have only been three quarters in its history, all in 1980 and 1981, when the index lost more 3%. During the recent quarter, the 10-Year Treasury yield increased to a high of 1.75%. While the move seems insignificant in absolute terms, the relative increase is one of the most drastic in history and has brought the long end of the Treasury market, as proxied by the Bloomberg U.S. Long Treasury Index, into bear market territory (declining by over 20% from peak prices last year). The move in rates is not that surprising given the recent confluence of factors: multi-trillion-dollar stimulus, the vaccine rollout, and the Federal Reserve's formal notice to markets that it is willing to tolerate higher inflation. That said, the magnitude and swiftness are historically unrivaled.[2]

Long-Term U.S. Treasury Bonds Enter Bear Market
Bloomberg U.S. Long Treasury Index Drawdown, *2/2/1973 - 3/31/2021*



Source: Bloomberg

In March, the Federal Reserve announced it would let the Supplementary Leverage Ratio program expire on March 31. The program was enacted during the depths of the crisis to ease Treasury market strains and promote lending.

In addition to COVID-19 vaccine developments and the Federal Reserve's willingness to err on the side of higher inflation, the unwind of a program modification enacted during the depths of the crisis, the Supplementary Leverage Ratio ("SLR"), may have also contributed to higher interest rates. An alteration to the SLR was implemented on May 15, 2020 in order to ease Treasury market strains and promote lending to households and businesses.[3] The adjustment allowed banks flexibility in what assets they could hold to meet regulatory requirements. More specifically, the Federal Reserve allowed banks to exclude Treasuries and cash from their capital requirement calculation. In the past several weeks, Senators Elizabeth Warren and Sherrod Brown made their views public on why the modified SLR should be allowed to expire. On March 19, the Federal Reserve announced it would let the modified SLR expire on March 31.[4]

From a fiscal and monetary policy perspective, several developments gave investors cause to celebrate. First, fiscal policy makers passed the American Rescue Plan Act of 2021.[5] This $1.9 trillion spending bill included $411 billion in direct payments to individuals, sending $1,400 to taxpayers earning up to $75,000 ($2,800 for married couples earning up to $150,000), plus an additional $1,400 per qualified child. The payments phase out for incomes up to $80,000 (or $160,000 for married couples).[6]

The American Rescue Plan Act of 2021 was passed by fiscal policy makers, and the Federal Reserve indicated it would continue its current policy stance for the foreseeable future giving investors cause to celebrate.

On the monetary side, the Federal Reserve did not make any new announcements, but it indicated it would continue its current stance for the foreseeable future, a noteworthy development. In its March meeting, the Federal Open Market Committee (FOMC) conveyed, through its dot-plot projections, that it would likely keep its federal funds rate at zero through 2023.[7] Furthermore, the committee reiterated its stance of conducting $120 billion of bond purchases per month, a pace that was never reached heading into or out of the credit crisis of 2008-09. The FOMC also released its "Summary of Economic Projections," which included its participants' expectations that the federal funds rate would remain at 0% through at least 2022.[8] On March 19, the *Wall Street Journal* published an article by Jerome Powell in which he wrote, "But the recovery is far from complete, so at the Fed we will continue to provide the economy with the support that is needs for as long as it takes."[9] That support means vast sums of money will continue to be pumped into capital markets and the economy.

GameStop found its stock as the top performing “meme stock” when a large group of traders from a popular forum on Reddit coordinated a buying raid of select stocks with unusual amounts of short-selling.

Several other events during the quarter revealed the unintended consequences of such abundant liquidity. In January, several so-called “meme stocks” sparked a revolution of sorts. The top performing of these was GameStop, which jumped over 1,000% as part of a short squeeze battle. A large group of traders, many from a popular forum on Reddit, coordinated a buying raid on select stocks that were contending with unusual amounts of short-selling (the percentage of the company’s total market capitalization that has been sold short). These raids in turn overwhelmed the supply of shares available to buy and spurred rapid price increases. Melvin Capital, a $12 billion hedge fund, came under liquidation pressure due to the meteoric rise of these shorted stocks.[10] The fund was down 53% in January due to its short exposure, and as a result, it had to be bailed out by high profile investors such as Steven A. Cohen and Citadel.[10]

Archegos Capital lost tens of billions after engaging in highly leveraged speculative bets on media and technology stocks. Archegos’ counterparties, Nomura and Credit Suisse, were among the hardest hit disclosing losses of $2 billion and $4.7 billion, respectively.

At the center of the melee was the free stock trading app, Robinhood. As a self-proclaimed champion of small and first-time investors, the company came under scrutiny for its handling of the GameStop situation, especially in light of the hundreds of millions of dollars it generated from selling trade order flow to market makers. In the aftermath of the market dysfunction and Congressional hearings on the subject, Robinhood reassessed the animated celebrations on its app, ultimately deciding to remove the digital confetti that virtually rained down after users make their first trade.[11]

Late in the quarter, Archegos Capital suffered tens of billions in losses once it was revealed that the firm engaged in highly leveraged speculative bets on media stocks such as ViacomCBS, Discovery, and Tencent.[12] The firm was able to gear up its exposure to multiples of its actual capital base using over-the-counter synthetic stock positions, which is why the unwind caught the market off guard. Some of those hit hardest in the unravelling were Archegos’ counterparties, Nomura and Credit Suisse. Nomura’s stock price endured its largest daily decline in history after the estimated $2 billion loss resulting from the exposure to Archegos was disclosed.[13] Credit Suisse disclosed a loss of $4.7 billion and announced a dividend cut as a result.[14]

On top of these implosions, Infinity Q Capital Management mutual fund revealed that one of their portfolio managers had access to and altered the third-party valuation (and pricing) of swap contracts. The fund has suspended redemptions indefinitely while it tries to get to the bottom of the issue.[15]

Although these events seem isolated, there is a common thread: accommodative monetary policies and apparently free-flowing cash have encouraged risk-seeking behavior and reduced the focus on risk management.

Policy

It is unlikely that the Federal Reserve is overly concerned by the recent rise in long-term interest rates, especially given that the S&P 500 surpassed 4,000 and hit new all-time highs in early April. That said, the Fed may already be using various tools to slow the pace of the rise in rates. On March 17, the FOMC kept in place its $120 billion per month of purchases of Treasury and agency mortgage-backed securities.[16] This consistent source of buying may prove to significantly shape the yield curve in the quarters ahead.

During the first quarter, the U.S. Treasury issued approximately $400 billion in bonds, and the Fed continued monthly purchases of $80 billion of Treasuries effectively monetizing sixty percent of total issuance.

Of the $120 billion in fixed income securities the Fed purchases every month, $80 billion are U.S. Treasuries. Considering that the U.S. Treasury issued approximately $400 billion in bonds during the first quarter, the Fed effectively monetized sixty percent of total issuance.[17] In the second quarter, the Treasury expects issuance to be just $95 billion, implying effective monetization of roughly three times the amount to be issued. While issuance is generally low in the second quarter because of federal tax receipts, it remains especially low in 2021 because the Treasury began the year with a colossal $1.7 trillion in cash. As of the end of March, the Treasury had a cash balance of $1.1 trillion.[18]

Markets

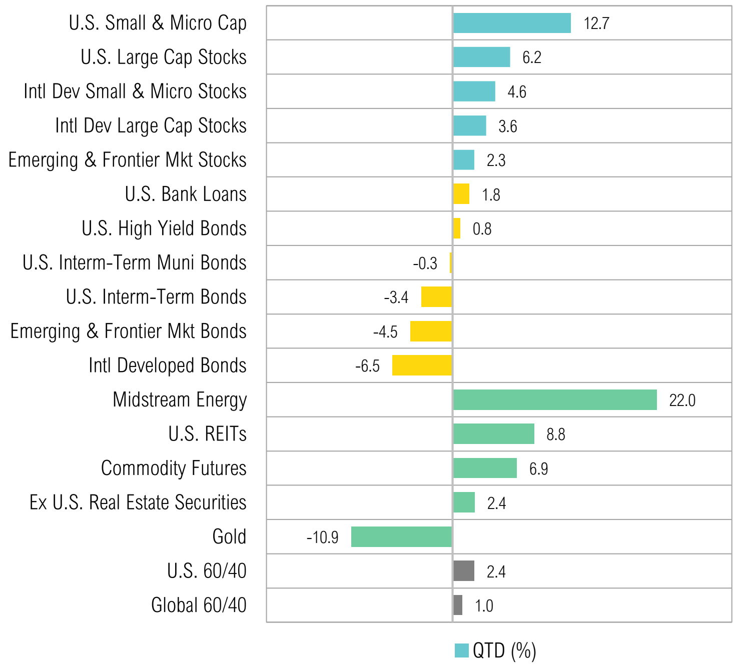
Value stocks outperformed growth stocks during the quarter while smaller companies outperformed larger companies. The Russell 2000 Value Index, a measure of small cap value stocks, outpaced all other equity asset classes with a gain of 21% during the first quarter. This followed a 33% gain in the fourth quarter of last year. The Russell 1000 Value Index, a measure of large cap value stocks, was higher by 11% during the quarter (following a 16% increase in the final quarter of 2020). The Russell 1000 Growth and 2000 Growth indices were up 1% and 5%, respectively. Energy was the best performing sector for the quarter, up 31%, while the technology sector rose just 2%. This performance reversed a portion of the 77% spread between the energy and technology sectors last year. Equities outside the U.S. once again trailed during the quarter. Developed market countries, as measured by the MSCI EAFE Index, returned 4% while emerging market stocks, as measured by the MSCI Emerging Markets Index, were higher by about 2%.

Estimates for S&P 500 operating earnings in 2021 are currently $172 per share—a 41% increase from 2020. This would represent a new high for earnings, eclipsing the $157 per share mark set in 2019.

Investor optimism has also extended to corporate earnings. Estimates for S&P 500 operating earnings in 2021 are currently $172 per share—a 41% increase from 2020.[19] This would represent a new high for earnings, eclipsing the $157 per share mark set in 2019. The S&P 500 currently trades at a one-year forward price-to-earnings ratio of 22 times, close to the tech bubble high of 26 times.

Municipal bonds, as measured by the Bloomberg Barclays Municipal 1-10 Year Bond Index, fared much better than investment-grade taxable bonds during the quarter as they lost less than 0.5%. The Bloomberg Barclays High Yield Index was able to absorb the rise in interest rates and post a gain of 0.8%.

March 2021 Key Market Total Returns



Source: Bloomberg

Looking Forward

At the end of the quarter, the Biden Administration announced an infrastructure plan, the American Jobs Plan, and the Made in America Tax Plan.[20] The infrastructure spending bill seeks to invest $2 trillion over the next decade, including 1% of GDP per year invested in infrastructure over the next eight years. The tax plan is designed to fund a portion of that investment by increasing the corporate tax rate to 28% and increasing the minimum tax on U.S. companies to 21% to avoid multi-national U.S. companies receiving an exemption on foreign asset returns. It is clear policymakers want nothing more than to keep accommodation at unsustainable levels for as long as they can. A key to this is the Federal Reserve's ability to continue to monetize these enormous spending bills. Given that risky assets and the U.S. dollar are relatively stable, capital markets appear willing to tolerate this path. Interest rates, too, appear well-contained, even with their recent rise.

From our viewpoint, inflation is the metric that will determine when the party is over and the confetti is swept away. If inflation creeps up, monetary and fiscal policy accommodation may need to be toned down. In the coming months, however, data on inflation will be hard to gauge because of the substantial stimulus measures, combined with the base effects as current prices are compared to the those of one year ago—the depths of the COVID-19 pandemic. Even more important than the data, though, is investors' reaction to it. As long as inflation remains contained, policymakers can continue to spend and monetize, and investors may be able to continue to throw the confetti.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

1. CDC: https://covid.cdc.gov/covid-data-tracker/#vaccinations
2. Bloomberg
3. Federal Reserve: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200515a.htm
4. Federal Reserve: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210319b.htm
5. CBS: https://www.cbsnews.com/news/biden-signs-covid-relief-bill-american-rescue-plan-into-law/
6. CBS: https://www.cnbc.com/2021/03/25/1400-dollar-stimulus-checks-went-to-some-people-who-do-not-need-them.html
7. CNBC: https://www.cnbc.com/2021/03/17/heres-where-the-federal-reserve-sees-interest-rates-the-economy-and-inflation-going-in-the-future.html
8. Federal Reserve: https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210317.htm
9. WSJ: https://www.wsj.com/articles/feds-powell-says-recovery-is-far-from-complete-11616445093
10. CNBC: https://www.cnbc.com/2021/01/31/melvin-capital-lost-more-than-50percent-after-betting-against-gamestop-wsj.html
11. Bloomberg: https://www.bloomberg.com/news/articles/2021-03-31/robinhood-ditches-its-confetti-animation-following-criticism
12. WSJ: https://www.wsj.com/articles/what-is-archegos-and-how-did-it-rattle-the-stock-market-11617044982
13. Nomura: https://www.nomuraholdings.com/investor/library/sec/6k/210329/210329.pdf
14. Credit Suisse: https://www.credit-suisse.com/about-us-news/en/articles/media-releases/trading-update-202104.html
15. SEC: https://www.sec.gov/rules/ic/2021/ic-34198.pdf
16. Federal Reserve: https://www.federalreserve.gov/newsevents/pressreleases/monetary20210317a1.htm
17. New York Fed: https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation/treasury-securities/treasury-securities-operational-details
18. U.S. Department of the Treasury: https://fsapps.fiscal.treasury.gov/dts/files/21033100.txt
19. S&P: https://www.spglobal.com/spdji/en/indices/equity/sp-500/#data
20. White House: https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/

DISCLAIMER

Magnus Financial Group LLC ("Magnus") did not produce and bears no responsibility for any part of this report whatsoever, including but not limited to any macroeconomic views, inaccuracies or any errors or omissions. Research and data used in the presentation have come from third-party sources that Magnus has not independently verified presentation and the opinions expressed are not by Magnus or its employees and are current only as of the time made and are subject to change without notice.

This report may include estimates, projections or other forward-looking statements, however, due to numerous factors, actual events may differ substantially from those presented. The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. Except for the historical information contained in this report, certain matters are forward-looking statements or projections that are dependent upon risks and uncertainties, including but not limited to factors and considerations such as general market volatility, global economic risk, geopolitical risk, currency risk and other country-specific factors, fiscal and monetary policy, the level of interest rates, security-specific risks, and historical market segment or sector performance relationships as they relate to the business and economic cycle.

Additionally, please be aware that past performance is not a guide to the future performance of any manager or strategy, and that the performance results and historical information provided displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, it should not be inferred that these results are indicative of the future performance of any strategy, index, fund, manager or group of managers. Index benchmarks contained in this report are provided so that performance can be compared with the performance of well-known and widely recognized indices. Index results assume the re-investment of all dividends and interest.

The information provided is not intended to be, and should not be construed as, investment, legal or tax advice nor should such information contained herein be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. An investor should consult with their financial advisor to determine the appropriate investment strategies and investment vehicles. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. This presentation makes no implied or express recommendations concerning the way any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's specific investment objectives.

Investment advisory services offered through Magnus; securities offered through third party custodial relationships. More information about Magnus can be found on its Form ADV at www.adviserinfo.sec.gov.

TERMS OF USE

This report is intended solely for the use of its recipient. There is a fee associated with the access to this report and the information and materials presented herein. Re-distribution or republication of this report and its contents are prohibited. Expert use is implied.

DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

About Magnus

Magnus Financial Group LLC is an SEC-registered, independent investment advisory firm located in New York City. Magnus provides customized wealth management and financial planning services for clients in all phases of their lives. As an independent RIA, Magnus provides high-quality service with a personalized client approach. Magnus was founded in 2017 and consists of approximately 15 staff professionals including four wealth advisors, investment operations, compliance and marketing, research and trading personnel, client service members and administrative support.

Learn more: Visit magnusfinancial.com

MAGNUS FINANCIAL GROUP

90 Park Avenue, Suite 1800,
New York, NY 10016

(800) 339-1367

service@magnusfinancial.com